No. 39. 8.

Reply Brf. of Knox & Willcox for Appellee.

Supreme Court of the United States.

Filed Nov. 18, 1898.

October Term, 1898.—No. 39.

Certiorari to the Circuit Court of Appeals for the Fourth Circuit.

THE SOUTHERN RAILWAY COMPANY,
Appellant,
against
THE CARNEGIE STEEL COMPANY, LIMITED,
Appellee.

NOVEMBER, 1898.

Brief,

For Appellee in Reply to Appellant's Supplemental Brief.

P. C. KNOX,
DAVID WILLCOX,
Of Counsel for Appellee.

C. G. Burgoyne, Walker and Centre Streets, N. Y.

SUPREME COURT OF THE UNITED STATES,

OCTOBER TERM, 1898. No. 39.

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THE SOUTHERN RAILWAY COMPANY,
Appellant,

AGAINST

THE CARNEGIE STEEL COMPANY, LIMITED,
Appellee.

November, 1898.

BRIEF,

for Appellee in reply to Appellant's Supplemental Brief.

As a matter of convenience it seems well to restate here the facts regarding the results of the operation of the property held by the receivers, and the diversion of the income from payment of current indebtedness of the company.

1. Receipts and expenditures upon the entire system.

(*a*) Insolvency receivers from June 17, 1892, to July 31, 1893 (p. 422):

Received from net earnings		$3,297,792 31
Expended as against the same:		
Car-trust payments	$209,500 00	
Sinking-fund payments	67,205 00	
Interest and Rentals	3,249,481 89	
Construction	232,134 34	
Equipment	81,390 32	
		$3,839,711 55

(*b*) Foreclosure receivers from August 1, 1893, to December 31, 1893 (p. 423) :

Received from net earnings		$1,127,861 09
Expended as against the same :		
Car-trust payments	51,160 00	
Sinking-fund payments	37,790 00	
Interest and Rentals	626,735 85	
Construction and Equipment	43,629 89	
		$759,315 74

(*c*) Both receiverships combined, from June 16, 1892, to December 31, 1893 :

Received from net earnings		4,425,653 40
Expended as against the same :		
Car-trust payments	$260,660 00	
Sinking-fund payments	104,995 00	
Interest and Rentals	3,876,217 74	
Construction and Equipment	357,154 55	
		4,599,027 29

2. Receipts and expenditures upon the Richmond and Danville road, taken alone and also with the "fixed leases."

Net earnings of insolvency receivers, from June 16, 1892, to August 1, 1893 (p. 402)		346,163 10
The earnings during the foreclosure receivership from the Richmond and Danville road are not separately stated, but at the same rate the earnings of both receiverships solely from the Richmond and Danville road were, approximately		550,000 00
Expended as against earnings upon the Richmond and Danville road proper (pp. 422, 423) :		
Construction—		
Insolvency receivers	$19,717 05	
Foreclosure receivers	9,232 61	
		28,949 66
Equipment—		
Insolvency receivers	74,733 28	
Foreclosure receivers	6,791 35	
		81,524 63

Car-trust payments—		
Insolvency receivers	209,500 00	
Foreclosure receivers	51,160 00	
		260,660 00
Total expended out of earnings upon the Richmond and Danville proper to increase the mortgage security		$371,134 29

In addition, the consolidated mortgage covered certain leaseholds, which are termed "fixed leases" (p. 402); with two unimportant exceptions, these were included in the decree of foreclosure (pp. 265-268). The receivers expended upon them the following further sums:

Construction—		
Insolvency receivers	$88,416 10	
Foreclosure receivers	8,874 40	
		97,290 50
This shows that out of the earnings between June 16, 1892, and December 31, 1893, there were expended for *construction* and *equipment* and *car-trust payments* upon the identical premises described in the consolidated mortgage		$468,424 79

None of this was for rails purchased from the appellee, because no such rails were purchased by the receivers until after December 31, 1893 (p. 245).

3. Floating debt of the Richmond and Danville Company now remaining unpaid (pp. 395, 398):

Total debt remaining unpaid		$318,324 71
Deduct Pullman Co. for car mileage	$90,752 81	
Western Union Co. for constructing telegraph lines	22,186 53	
		112,939 34
Claims for materials and supplies remaining unpaid consisting of:		$205,385 37
Carnegie Co. for rails	$125,067 39	
All others	80,317 98	

This shows that the income, not only of the insolvency receivership, but also of the foreclosure receivership, was expended upon

the property in order to hold it together for the bondholders, while these obligations for materials and supplies were allowed to remain unpaid.

FIRST.

The diversion of current earnings has been fully established.

The Supplemental Brief denies the statement that the car-trust and rental payments were "made for the purpose of keeping "the property together for the benefit of the bondholders." The facts upon the subject are stated in detail on pages 29 and 30 of the Principal Brief for the Appellee. At the beginning of the proceedings on June 15, 1892, that was stated in the Clyde bill as the object of the suit (pp. 14-16). Upon June 28, 1892, in the petition for leave to issue receivers' certificates, it was said that the object was to "preserve the system of roads against dismemberment * * "as well as to preserve and increase the present market value of the "bonds and stocks belonging to the receivership" (p. 26). On this petition and notice to the trustee under the consolidated mortgage, an order was made authorizing the receivers to apply the income coming into their hands to payment of car trusts and rentals (pp. 25, 137). The accounts of the receivers, as above stated, show that this application of the income was made during the eighteen months of the two receiverships to the extent of $4,136,877.74. The reorganization agreement of May 1, 1893, stated that this had been done because it was "sought to hold together the various "properties embraced in the system," (p. 512) and in so doing the "receivers had become so depleted of cash" that they had been obliged to default upon obligations prior to the consolidated mortgage (p. 533, note †). This establishes that the intention was to hold the property together for the benefit of the bondholders, and that the income of the receivership was expended for that purpose.

Exhibit B, p. 431, to which the Supplemental Brief refers, shows that between August 1 and November 30, 1893, the foreclosure receivers paid rentals on ten leased roads. Accordingly, in the foreclosure

decree eight of the principal leaseholds were decreed to be sold (pp. 264–268), and they were bought in by the reorganization committee and conveyed to this appellant (pp. 295, 296). This makes it clear that the property was in fact held together for the benefit of the bondholders by this expenditure of the income of the receivership. Indeed, the Supplemental Brief itself states (p. 4) that some of the leaseholds "were indispensable to any profitable working of the "Richmond and Danville Railroad."

But, as appears above (*supra*, pp. 1-3), the diversion did not consist merely in Interest and Car Trust payments. During the insolvency receivership there was expended for Construction and Equipment the sum of $313,524.66 and during the foreclosure receivership for the same purposes the sum of $43,629.89. In Burnham vs. Bowen, 111 U. S., 776, expenditures of exactly the same character were made by a receiver. It was held that this constituted diversion and that a creditor of the company who had taken its acceptances, and even renewed them after the receiver was appointed, was entitled to payment prior to the bondholders.

The Supplemental Brief vigorously claims that the consolidated mortgage bondholders were not chargeable with anything done in the Clyde suit. Under date of June 28, 1892, the complainants in that case petitioned for an order allowing the receivers to divert the income from payment of current expenses. An order to that effect was made upon the following day after hearing counsel for the Central Trust Company, the trustee under the consolidated mortgage (p. 135). The fact that counsel attended upon one day's notice and made no opposition, indicates that the order was made with the co-operation of the Trust Company.

Importance is attached to the fact that when the Central Trust Company was granted leave to formally intervene in the insolvency suit, its petition did not set forth that it was trustee under the consolidated mortgage. But that is a matter of very little consequence. As just shown, the Trust Company, upon June 28, 1892, had co-operated in the order authorizing the receivers to divert the income to payment of rentals and car trusts (pp. 28, 135, 167, 168). Upon July 13, 1892, the Trust Company filed a petition praying to be allowed to intervene (pp. 138-141). It is true that this did not enumerate the many mortgages under which the Trust

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Company was the trustee, and specified merely the first mortgage and the emergency loan. But by a paper dated upon August 10, 1892, the Trust Company, as trustee under the *consolidated* mortgage, requested the court, if it should determine to continue its judicial possession of the property, to appoint Huidekoper and Foster receivers (p. 167). After the date of that request and upon August 16, 1892, an order was entered allowing the Trust Company to intervene generally and not as trustee under any specific mortgage, "on the condition that it hereby submits to the several orders heretofore entered herein" (p. 167). Subsequent orders were regularly made on notice to the Central Trust Company generally (pp. 186, 194, 205, 208, 217).

There is, therefore, no question that the corporation which was trustee under the consolidated mortgage had notice of everything done in the Clyde case, and, whenever it saw fit, acted in behalf of the bondholders secured thereby. The question upon which the Supplemental Brief lays such stress is whether the Trust Company was a party to the suit as trustee of the various mortgages, or only of two of them. This distinction is so minute as to be without importance. But, in any event, it must be deemed settled by the terms of the order which made the Trust Company a party generally without any distinction as to the various mortgages under which, as it had already advised the court, it was trustee. This made it a party for all purposes, and it was in court in behalf of whatever interests it had in the subject matter.

In any event, this point affects nothing save the action of the insolvency receivers. But after the bill was filed to foreclose the *consolidated* mortgage and the receivers were appointed thereunder, with the consent of all parties, an order was entered (p. 245) authorizing them to continue the same course of diverting the earnings, and this they accordingly did. As above stated, between August 1, 1893, and December 31, 1893, the foreclosure receivers paid out for Interest and Rentals, $626,735.85; for Car Trusts, $51,160; for Construction and Equipment, $43,629.89. This diversion was made in the foreclosure suit of the *consolidated* bondholders themselves. There can, therefore, be no question in regard to their acquiescence in it, and the amount was far more than sufficient to pay the appellee. In view of these circumstances, under Burnham vs. Bowen, 111 U. S., 776, and Virginia and Ala-

bama Coal Co. vs. Central Railroad Co., 170 U. S., 355, the decree in appellee's favor was correct.

The statement is made (Supplemental Brief, p. 7) that the insolvency receivership was a burden upon the consolidated bondholders. So far as concerns the expenses of the insolvency receivership, this was not the case. The payments and receipts of the foreclosure receivers on account of the prior receivership were as follows (pp. 426, 427):

Pay rolls	$467,562 79	
Loss and damage claims	4,163 45	
Traffic balances	53,257 20	
		$524,983 44
Materials and supplies		515,877 87
Total paid by foreclosure receivers on account of insolvency receivership		$1,040,861 31
As against this there was received on account of the former receivership:		
Cash	$141,325 19	
Accounts collected	384,473 10	525,798 29
Balance paid		$515,063 02

This balance was almost exactly the amount paid for materials and supplies. But when the new company took possession, it received material and supplies to the amount of $500,000 from the foreclosure receivers (p. 303). This shows that the material and supplies for which the insolvency receivers had contracted came into possession of the foreclosure receivers, and the estate accordingly was not diminished by payment therefor by the latter receivers.

So far as concerns the arrears of interest during the insolvency receivership and the issue of receivers' certificates (Supplemental Brief, p. 7), it has been already pointed out, and was stated in terms in the reorganization agreement, that these were the results of the effort to "hold together the various properties embraced in "the system" in the interest of the bondholders (pp. 512, 533, note†). That effort has proved successful as is shown by the existence of the appellant. The appellant, therefore, is not in a position to complain that when the estate came into the hands of the foreclosure receivers it was burdened by the results of the effort.

SECOND.

There is nothing in the objections urged to the appellee's standing as a supply creditor.

In the Supplemental Brief (pp. 7, 8) the appellant repeats the claim already urged in its Principal Briefs—that the cost of these rails is to be regarded as a permanent betterment, and not as an expense necessary to keep the road in operation.

In support of this contention is cited Mackintosh vs. Railroad Co., 34 Fed. Rep., 582. That was a controversy between two classes of stockholders under a reorganization. The reorganization agreement provided that the holders of common stock had no rights, but were merely "provisional stockholders", until the preferred stock had been paid seven successive annual dividends of seven per cent. The new charter provided that the funds applicable to the payment of such dividends were the net income "after paying interest on prior bonds, repairs, expenses "of equipment," etc. At the first meeting of the Board of Directors it was resolved that "under operating expenses only such "improvements and additions shall be included as are necessary to "keep the property efficient, and that all beyond this shall be pro- "vided for out of funds other than net earnings." It appeared that a very considerable sum had been expended in replacing iron rails with steel rails, using the iron rails for sidings. The expenses of these changes were in great part charged against the earnings, instead of being charged to new construction. The court said that the fact that the charter provided that repairs should be paid out of the net income did not, as between the two classes of stockholders, warrant this method of dealing with the earnings of the company. "Its effect was not "to keep the track in repair—*in the same state of efficiency* as it "existed in on October 1, 1880—but to improve and enhance its "value at the expense of earnings, which are thus reduced, and the "provisional stockholders correspondingly postponed" (p. 608). Reference is also made to the case of Grant vs. Railroad Co., 93 U. S., 225. The point decided there was that the expression "profits used in construction," within the meaning of the Internal Revenue Act, did not embrace earnings expended in repairs for keeping the property up to its normal condition.

Second. There is nothing in the objections urged to appellee's standing as a supply creditor.

These authorities have no application to the present case. The record does not show that these rails were used for new construction; it shows, on the contrary, that they were used merely in order to maintain the property in suitable condition for operation. The rails were purchased from the appellee generally and not for use in relaying any special portion of the track or in constructing any new track (pp. 370-372). The testimony of the General Manager (pp. 482-484) shows that the rails were distributed over various parts of the system. These rails were, of course, all used prior to the appointment of the receivers. Upon August 12, 1892, very shortly after their appointment the receivers filed a report stating that the financial difficulties of the Railroad Company during the last two years had "prevented the "operating officers from being able to expend the proper amount "*for new rails*, and upon the roadbed and structures, *to keep the* "*railroad in the condition in which it should be maintained*, and "it will be necessary for the receivers, during the summer and "autumn to make a much larger expenditure than they would for "ordinary maintenance" (p. 166). Upon January 16, 1894, the foreclosure receivers again stated (p. 246) in a petition to the court that "*for the proper and economical operation* of the lines of railroad "of which they are receivers, and *for the safety of passengers and* "*property transported over such roads*, two thousand tons of new "steels rails are an absolute necessity," and an order of the court was made authorizing purchase of the same (p. 247). Upon April 13, 1894, the same receivers again stated in a petition to the court that "for the *proper, safe and economical operation* of the lines of rail-"road over which they are receivers, and the *proper and safe* "handling of the freight and passenger business on said roads, as "required by the orders of this court appointing them as receivers, "they require at the present time about twenty-five hundred (2,500) "tons of steel rails" (p. 251), and an order of the court was made authorizing the purchase of such rails (p. 252). In the face of these facts there is no warrant for claiming that the rails now involved, which were purchased in 1891, were used for new construction rather than for the purpose of maintaining the road in a condition suitable for operation.

Attention may again be called to the fact that in Farmers' Loan

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and Trust Co. vs. Railway Co., 33 Fed. Rep., 778, where question was raised precisely with reference to claims preferential to the mortgage, it was held that steel rails were entitled to preferential payment as coming within the description of expenses of operation. Objection was made that they were properly betterments, but the court said, "this objection is untenable, for if these "betterments were necessary, and added to the value of the security "held by the bondholders, and were made without objection on "their part, they cannot be heard to complain" (pp. 785, 786). Similarly it has recently been held in N. Y. Guaranty & Indemnity Co. vs. Railway Co., 83 Fed. Rep., 365, that the cost of a steel cable must be regarded as a preferential operating expense. So, too, in Hale vs. Frost, 99 U. S., 389, and Wood vs. Railway Co., 70 Fed. Rep., 741; 75 Fed. Rep., 54, 59, it was held that material furnished in order to keep the equipment in condition for use must be regarded as of the same character. It is clear that there is no distinction in principle between material furnished for repairs upon the equipment and that furnished for repairs upon the roadbed. Each constitutes a very large part of the invested capital of the company, and as to each there is the same necessity to maintain it in condition for efficient operation.

The equitable rights of the appellee as a supply creditor are fully supported by Burnham vs. Bowen, 111 U. S., 776, and Virginia & Alabama Coal Co. vs. Railway Co., 170 U. S., 355, together with the other authorities upon the subject cited upon the appellee's Principal Brief (pp. 15–28). It is significant that neither the Principal Briefs nor the Supplemental Brief on behalf of the appellant make any substantial effort to distinguish these cases. In fact, so far as concerns the Coal Company case, its existence is practically ignored.

THIRD.

The suggestions of the Supplemental Brief regarding the effect of the reorganization are without weight.

1. The record fully presents the questions heretofore urged in that regard by the appellee.

The Reorganization Agreement was attached to the intervening petition of the appellee, setting forth its rights and praying enforcement thereof (pp. 365–370, 503–563). It was admitted by the answer to said petition (pp. 376, 377, 378), and was referred to as in the case in a stipulation filed with the Masters regarding the issue of securities under the reorganization agreement (p. 386). The agreement was, therefore, a part of the pleadings which were before the Masters when they passed upon the claim of the appellee. As it was set up in the petition and admitted by the answer, it was, of course, not necessary to offer the agreement in evidence.

The hearing before the Masters was closed upon May 18, 1894 (p. 381), and the sale did not take place until June 15, 1894 (p. 289). So that it would not have been practicable to introduce testimony to show that the reorganization was carried into effect. That, however, appears from the record, because it shows that the property was sold upon June 15, 1894 (p. 289); and was purchased by the purchasing committee of the bondholders (pp. 290, 291) who vested title in a new corporation to be known as the Southern Railway Company (p. 294), and that the Southern Railway Company was accepted as the purchaser by order of court entered upon June 15, 1894, upon condition that it should pay such further claims as it might be directed by the court (p. 301). The corporation thus created is the present appellant. The files of the court sufficiently show these facts. They are not and cannot be controverted in any respect.

The real purchasers of the property are the reorganized stockholders of the former company. They are its owners under the name of the Southern Railway Company. This court of equity still has control of the property for the purpose of compelling the purchaser to do equity as regards claims generally against the property (pp. 280, 282, 301). As the reorganization

Third. The suggestions of the Supplemental Brief regarding the effect of the reorganization are without weight.

agreement provides that the stockholders of the former company shall still have an interest in the property to the exclusion of its floating debt, it is entirely competent for the court to direct that the stockholders as reorganized shall pay that floating debt. The remedy by independent bill would be extremely slow and, as the parties interested, namely, the appellant and the appellee, and also the subject matter are under the full control of the court, and the facts cannot be denied, there is no reason why the appellee should be remitted to an independent bill which might raise difficult questions regarding the jurisdiction and the remedy. Certainly the statement of the Supplemental Brief that the purchase contemplated by the reorganization plan may never be consummated, is entitled to no weight in view of the fact that the party which makes that statement is shown by the record to be the product and result of that purchase.

2. There is no merit in the distinction sought to be made between the present case and Railroad Co. vs. Howard, 7 Wall., 292.

The suggestion is made that the present case differs from the Howard case because in the latter the bill sought a ratable application of the fund among all unsecured creditors, while here the appellee is seeking satisfaction merely of its own debt. But this is not an accurate statement of the position. The present appellee is asserting its own claim, but this does not affect in any respect the rights of those similarly situated, and no effort is made here to prejudice those rights. As already shown (*supra*, p. 3) the amount of those claims is very small; probably they also are entitled to payment.

As regards the amounts to be received under the terms of the reorganization plan by the stockholders of the Richmond and Danville Company, the facts are fully stated upon pages 48 and 49 of the Principal Brief for the appellee. It will be seen from that statement that the holders of both bonds and preferred and common stock of the Terminal Company received new preferred stock and new common stock for the express reason that they already held the capital stock of the Richmond and Danville Company, and that none of these holders of Terminal securities paid any assessment, save the holders of the common stock. They, it is true, were to pay in a large amount to clear

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off the debt of the Richmond and Danville Company. This doubtless appeared to counsel who prepared the plan necessary by reason of the Howard case. But no part of this fund has been applied to paying the debts of the appellee and a few others. Why this is the fact the record does not disclose.

It is sought to distinguish the Howard case upon the ground that the mortgage bondholders, there in express terms released and discharged their lien upon the portion of the proceeds of sale payable to the stockholders of the former company, and that, therefore, that portion was assets of the Railway Company. This does not really distinguish that case from the present. There the lien was discharged only by the reorganization agreement in the manner therein prescribed. So, too, here it could properly be said that the consolidated bondholders released their rights against the securities representing the interest of the stockholders in the new company. The reservation contained in the reorganization agreement which is set forth in the Supplemental Brief (pp. 13, 14), therefore, has no bearing upon this question; for it was evidently useless to provide that the claims of all stockholders and creditors should be cut off by the foreclosure, while at the same time a substantial interest in the property was secured by the reorganization to the stockholders, but the creditors were left unpaid. The precise point ruled in the Howard case is that this cannot be done.

The objections urged regarding the rights of the appellees in view of the reorganization are based upon technical refinements. It is submitted that as there is no question as to the facts, the parties are before the court and the property is still within its control, the court will dispose of the matter upon the merits. It is not accurate to speak of the question as one regarding the proceeds of the sale; the point is really whether the reorganized stockholders of the debtor company shall pay its debts before dividing among themselves whatever equity there may be in its property.

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David Willcox,
Of Counsel.